No. 12500

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

ALEXANDER & BALDWIN, LIMITED,
Appellant,

vs.

AGNES M. KANNE, Executrix under the Will and of the Estate of Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii.
Appellee.

Upon Appeal from the United States District Court District of Hawaii

BRIEF FOR APPELLANT ALEXANDER & BALDWIN, LIMITED

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OPINION BELOW

The Opinion of the District Court (R. 14-21) is reported at 76 F. Supp. 133.

STATEMENT OF THE PLEADINGS AND THE FACTS

This is an appeal by Alexander & Baldwin, Limited, plaintiff-appellant against Fred H. Kanne, Collector of Internal Revenue for the United States for the District of Hawaii, defendant. The suit was brought in the United States District Court for the District of Hawaii on July 21, 1942, to recover income taxes and interest thereon for the calendar year 1932 alleged to have been erroneously and illegally exacted from plaintiff by the said Fred H. Kanne (R. 2-7). An Answer was filed by the defendant on October 17, 1942 (R. 7-9). On October 28, 1943, plaintiff filed a Motion to Amend Complaint (R. 9-10) and an Order Granting Motion to Amend (R. 11) was entered on November 3, 1943. Subsequently, defendant Kanne died and his executrix Agnes M. Kanne was substituted as defendant by Order of Court (R. 13).

Jurisdiction of the District Court was invoked under 28 U.S.C. Sec. 41 (5), now 28 U.S.C. Sec. 1340. The judgment of the District Court was entered on December 7, 1949 (R. 47-48) pursuant to the Opinion of the Court filed on November 18, 1948 (R. 14-21) and Findings of Fact and Conclusions of Law filed on December 7, 1949 (R. 22-46). Alexander & Baldwin, Limited filed Notice of Appeal to the United States Court of Appeals for the Ninth Circuit on February 2, 1950 (R. 50). The jurisdiction of this Court is invoked under the provisions of Section 128 of the Judicial Code, as amended, now 28 U.S.C. Sec. 1291.

STATEMENT OF CASE

Alexander & Baldwin, Limited, plaintiff-appellant, (hereinafter called Alexander & Baldwin) is a Hawaiian corporation having its principal office in Honolulu, Territory of Hawaii. Alexander & Baldwin for the purpose of comput-

ing its Federal Income Taxes is and has been at all times on the calendar year and cash basis and follows the actual method of charging off bad debts (R. 71).

In its Federal Income Tax Return for the taxable year 1932, Alexander & Baldwin deducted the amount of $50,000.00 on account of a bad debt of Henry Waterhouse Trust Company, Limited, written off during the year 1932 (R.72). The Commissioner of Internal Revenue disallowed the bad debt deduction and assessed additional income taxes on account thereof which Alexander & Baldwin paid to defendant Kanne upon demand. The District Court in its decision upheld the Commissioner of Internal Revenue and disallowed the deduction of the bad debt of Henry Waterhouse Trust Company, Limited.

In 1932 Alexander & Baldwin was the agent for five companies operating sugar plantations, three companies operating pineapple plantations, two ranches and two railroad and stevedoring companies, with a total net worth of $49,293,366.00. In the same year, Alexander & Baldwin's investment in the securities of the companies for which it acted as agent or factor amounted to over $11,000,000.00. In addition, Alexander & Baldwin, the plaintiff herein, had other investments including an investment of $1,250,000. in its home office building in Honolulu, Territory of Hawaii. On December 30, 1930, Alexander & Baldwin and the companies for which it served as agent or factor had on deposit in the banks of the Territory of Hawaii at least a total sum of $2,275,000.00 (R. 55-56).

The Henry Waterhouse Trust Company, Limited, hereinafter called Waterhouse Company, was incorporated under the laws of the Territory of Hawaii. In the middle of October, 1930, Waterhouse Company increased its capital stock from $200,000 to $400,000, consisting of 4,000 shares of a par value of $100 each. The new shares were all taken by the old stockholders who paid for them in cash at par.

In November, the effects of the general business depression began to be felt in the Territory of Hawaii, and as a large part of the Waterhouse Company assets consisted of real estate and mortgages, its secretary became apprehensive that if many calls were made on its demand accounts the Company's financial condition would not be sufficiently liquid to meet its cash requirements. He discussed the situation with the treasurer and auditor of Waterhouse Company and then advised the management of Bishop Trust Company, Limited, hereinafter called Bishop Trust, that a sale of the stock might be arranged, suggesting a price of $100 each or more for the shares.

In November, 1930, Mr. A. W. T. Bottomley, president of two large Hawaiian corporations and vice-president and director of Bishop Trust, called Mr. E. J. Greaney, an auditor, to his office and requested him to make a confidential examination of the books and accounts of Waterhouse Company[1] (Am. Fac. R. 488). Mr. Greaney entered upon the audit and in connection with this work made an exhaustive appraisal of the value of the various receivables of the Waterhouse Company (Am. Fac. R. 489-492, 499-500, 502-505).

Mr. A. W. T. Bottomley, president of American Factors, Limited, and of the Bishop First National Bank of Honolulu and vice-president of the Bishop Trust Company, called a conference of the heads of the four Hawaiian sugar agencies including appellant, the president of the Bank of Hawaii, Limited, the president of the Hawaiian Trust Company, Limited, and two members of the finance committee of the

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[1] By order of this Court (R. 100) pursuant to a stipulation entered into by and between counsel (R. 99), the Court agreed to consider the testimony of the appellant's witnesses from the record heretofore printed in Case No. 12391, Kanne v. American Factors, now pending on the calendar of this Court. When reference is made to appellant's record, the designation R. followed by the page number will be used and when reference is made to the record in Case No. 12391, the designation Am. Fac. R. will be used.

Bishop Trust Company, Limited, to present to them the financial condition of the Waterhouse Company and discuss the feasibility of making some plan to prevent the Waterhouse Company from being forced into liquidation.

The Waterhouse Company was conducting business as usual but was encountering some financial difficulties. After the investigation, the executives of the Bishop Trust Company, Limited, wished to look further into the matter before acting. About February 1, 1931, the Bishop Trust Company, Limited, advised the Waterhouse Company shareholders that it would not pay cash for their shares.

On Saturday, February 14, 1931, the president of Bishop Trust at a meeting of the Board of Directors of that company made a statement which was recorded in the minutes (Am. Fac. R. 380-382). In brief, it was proposed that Bishop Trust acquire the stock of Waterhouse Company without cost; that Mr. and Mrs. R. W. Shingle in order to settle their indebtedness to the Waterhouse Company pay the amount of $535,000, and convey their respective 18% and 10% undivided interests in certain lands which were to be sold for $87,000; and the proceeds, together with $13,000 in addition, were to be contributed by Bishop Trust to make an even $100,000 to be paid into Waterhouse Company (Am. Fac. R. 380-382).

In addition, a number of corporations and individuals were to loan various sums aggregating $400,000 and to receive notes therefor (Ex. A, R. 62), thus making a total of $1,035,000 cash to be paid into Waterhouse Company. Bishop Trust was to pay such an amount, if any, as was required in addition to enable the Waterhouse Company to meet its liabilities. Bishop Trust was to take over without further cost the business of Waterhouse Company (other than assets and liabilities) and to operate such business at its own expense and for its own benefit (Am. Fac. R. 380-382). Under the plan, the assets were to be liquidated and

the liabilities paid and in final settlement, if there was an excess of assets over liabilities, such excess was to be applied first to the reimbursement of the amount contributed by Bishop Trust, if any, in addition to the said $1,035,000 and secondly, to the lenders of the $400,000 with interest at 4%, and thirdly, the remainder, if any, was to go to Bishop Trust (Am. Fac. R. 382). The plan as outlined was approved by the Board of Directors of Bishop Trust at the meeting held on February 14, 1931. Prior to the consummation of the plan hereinabove mentioned the several individuals and corporations promised to pay to Waterhouse Company, upon the consummation of the proposed plan, sums of money aggregating $400,000, of which amount appellant agreed to pay the amount of Fifty Thousand Dollars ($50,000) (Am. Fac. R. 62).

The plan of reorganization of Waterhouse Company was carried out as outlined above and the several individuals and corporations paid into the Waterhouse Company the amounts of money aggregating $400,000. On February 25, 1931, the Board of Directors of Alexander & Baldwin authorized the payment of $50,000 to the Waterhouse Company (Ex. B, R. 76). Alexander & Baldwin and each of the persons and corporations lending money to the Bishop Trust under the agreement received notes which were identical in form. A copy of the note delivered to Alexander & Baldwin is shown in Exhibit J (R. 86).

An advisory committee of the lenders was appointed to pass upon the program of liquidation, the members of the advisory committee being shown at R. 67. This committee met frequently with the finance committee of the Waterhouse Company and passed upon all matters of importance, particularly those matters tending to affect the amount of reimbursement, if any, ultimately to be made to the special note owners (R. 68).

Under the date of July 18, 1932, Waterhouse Company, dispatched to the appellant, a letter signed by M. B. Henshaw (a true copy of which is marked Exhibit M and shown at R. 89) stating that early in 1932 the advisory and finance committees of Waterhouse Company decided that it was advisable to reappraise the assets and that such reappraisal disclosed that its liabilities other than that to the lenders and stockholders exceeded the value of the assets by a very considerable amount and advised them that the note had now become worthless (R. 89-90).

Mr. Carl R. Linden, employed as a tax advisor for appellant, testified that in the year 1932 he reviewed the note received by Alexander & Baldwin with Mr. Sherwood Lowrey, treasurer of American Factors, Limited, a holder of a similar note. Mr. Linden indicated that Mr. Lowrey was firmly of the opinion that there was no possibility of any recovery being made on the note (Am. Fac. R. 543). The witness testified further that he also discussed the matter with Mr. John Waterhouse, President and General Manager of Alexander & Baldwin, the latter also expressing the opinion that there was no possibility of any recovery on the note (Am. Fac. R. 543). As a result, officers of appellant reached the conclusion that the note was valueless and accordingly it was written off and claimed as a tax deduction for the year 1932 (Am. Fac. R. 543-544).

QUESTION INVOLVED

(1) Is Alexander & Baldwin, Limited, entitled to a deduction of the amount of $50,000 advanced to it by Waterhouse Company and charged off as worthless in the year 1932, as a bad debt or as an ordinary or necessary expense of carrying on its business in the year 1932 in the computation of its Federal income tax liability for the year 1932?

SPECIFICATION OF ERRORS RELIED ON

The United States District Court for the District of Hawaii erred:

1. In concluding that the payment in 1931 by the plaintiff of $50,000.00 to Henry Waterhouse Trust Company, Limited, was just a contribution.

2. In concluding that the note for $50,000.00 given by Henry Waterhouse Trust Company, Limited in 1931 was contingent in value and was subject to such conditions as to render it non-negotiable and in concluding that the note was without any negotiable value at the time it was made and at all times thereafter.

3. In concluding that the note given by Henry Waterhouse Trust Company, Limited, to the plaintiff in 1931 could not be dealt with as a debt.

4. In concluding that the contingencies as to value and/or the lack of negotiable value prevented said note from being an evidence of debt.

5. In concluding that the Commissioner of Internal Revenue did not err in disallowing plaintiff a deduction therefor as a bad debt in computing its taxable net income for the calendar year 1932.

6. In concluding that no part of the payment of $50,000.00 made to Henry Waterhouse Trust Company, Limited, in 1931 by plaintiff was deductible as a bad debt ascertained to be worthless and charged off within the tax year 1932 or as an ordinary or necessary expense of carrying on its business for the year 1932.

7. In failing to render judgment in favor of plaintiff on account of plaintiff's overpayment of income tax for the year 1932 for the amount of $8,488.63 with interest thereon instead of the amount of $137.50 with interest thereon in the amount of $28.94.

SUMMARY OF ARGUMENT

THE COURT ERRED IN DISALLOWING ALEXANDER & BALDWIN, LIMITED, THE DEDUCTION OF THE PAYMENT OF $50,000 TO WATERHOUSE COMPANY IN 1931 IN COMPUTING ITS TAXABLE NET INCOME FOR THE CALENDAR YEAR 1932.

1. The sum of $50,000 representing the amount paid to Waterhouse Company in 1931 was deductible as a bad debt determined to be worthless and charged off in the tax year 1932.

The payment of $50,000 made by Alexander & Baldwin to Waterhouse Company in 1931 constituted a loan which was to be repaid from the liquidation of the assets of Waterhouse Company. The evidence adduced in the Trial Court clearly shows that the payment was in no sense a gift or contribution but on the contrary was a loan made with a reasonable expectation of repayment. It was only when the effects of the depression became more pronounced in Hawaii that the note was ascertained to be worthless and charged off in the year 1932.

2. In the alternative, if not deductible as a bad debt the sum of $50,000 representing the amount paid to Waterhouse Company in 1931 was deductible as an ordinary and necessary business expense of Alexander & Baldwin, Limited, in the year 1932.

The payment of $50,000 made by Alexander & Baldwin to Waterhouse Company in 1931 in substance and reality was an expense incurred by Alexander & Baldwin in an effort to protect its vital interests in the community. There is ample evidence in the record to show that Alexander & Baldwin would have suffered a direct loss if the Waterhouse Company had failed. The advancement of funds under

similar circumstances during the critical early "thirties" constituted an expenditure which the Courts have held to be deductible as both an "ordinary and necessary" business expense.

ARGUMENT

I.

THE COURT ERRED IN DISALLOWING ALEXANDER & BALDWIN, LIMITED, THE DEDUCTION OF THE PAYMENT OF $50,000 TO WATERHOUSE COMPANY IN 1931 IN COMPUTING ITS TAXABLE NET INCOME FOR THE CALENDAR YEAR 1932.

1. The sum of $50,000 representing the amount paid to Waterhouse Company in 1931 was deductible as a bad debt determined to be worthless and charged off in the tax year 1932.

Section 23 of the Revenue Act of 1932 pertaining to the deduction of bad debts is as follows: " (j) Bad Debts.—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts) ; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction."

The District Court in its opinion (R. 20) holds that the payment of $50,000 made by the appellant to the Waterhouse Company was "just a contribution." The Court remarks further that "The note given in acknowledgment of the contribution was contingent as to value upon such conditions as to give it no negotiable value from the time it was made. It could not be dealt with as a debt. The considerations in payment for the contribution flowed to the payee of the note at the time it was made—the protection of the commercial community, sympathy toward Water-

house Company clients who could ill afford to lose, and other commendable desires and motives of helpfulness and security, but there was no attempt to show that either American Factors or Alexander & Baldwin would have suffered any material loss had they not attempted to keep the Waterhouse Trust Company a going concern.

"I find that no part of this contribution was deductible as a bad debt or loss in 1932 or at any other time, since it never was a collectible debt, but was from the beginning in the nature of a contingent or speculative gift, to which status it speedily resolved itself with certainty, although it may have accomplished in part the purpose for which it was intended, that is, prolonged the life of Waterhouse Trust Company. Claim for tax refund on this outgoing sum of $50,000 is denied" (R. 20).

In brief, the District Court held (1) that the payment of $50,000 made by appellant to the Waterhouse Company was a contribution in the nature of a contingent or speculative gift; (2) that the note received by appellant was contingent as to value upon such conditions so that it had no negotiable value (Finding of Facts No. XIII, R. 40); (3) that the consideration for the contribution included the protection of the commercial community, sympathy for clients of Waterhouse Company and other commendable desires and motives of helpfulness and security (Finding of Facts No. XIII, R. 40); (4) there was no attempt to show that Alexander & Baldwin would have suffered any material loss had it not attempted to keep Waterhouse Company a going concern (Finding of Facts No. XIII, R. 40); (5) that there never was a collectible debt but merely a contingent or speculative gift, even though it may have accomplished in part the purpose of prolonging the life of Waterhouse Company. It is submitted to the Court that Finding of Fact No. XIII which incorporates the findings of the Court set forth in the opinion is not in accord with the facts set

forth in the stipulation between the parties (R. 54), nor with the evidence adduced upon the trial of this cause.

First, we will consider the several factors which clearly indicate the error of the Court's finding that the payment of appellant constituted a contribution or gift. The Appellate Court's attention is directed to the complex and involved nature of the plan under which the payment of the funds was made (Finding of Fact No. IX, R. 28). Note, for example, the requirement that Bishop Trust Company was to keep separate accounting records of the assets of Waterhouse Company, which records were to be made available to the several note holders (R. 30-32). The provision for an advisory committee for the note holders also argues strongly against the finding that the payment in question represented a gift. It is submitted to the Court that experienced businessmen would hardly be likely to set up such a comprehensive and elaborate plan unless there was at least a reasonable expectation of repayment.

A further cogent argument against the validity of the Court's finding is found in the testimony of several of appellant's witnesses on the trial of this cause. Mr. Sherwood Lowrey, treasurer of American Factors (which company was also a note holder), testified that executives of American Factors believed there was a reasonable expectation that the note would be paid (Am. Fac. R. 474). Mr. Lowrey testified further that at the end of 1931, the note together with other receivables was reviewed by Company officials and at that time American Factors considered the note as good (Am. Fac. R. 466-467).

Mr. A. L. Castle, who represented his father in connection with the loan made by the latter to the Waterhouse Company, testified that the payment was made to the Waterhouse Company "on a loan basis" (Am. Fac. R. 511).

Mr. Arthur L. Dean, a director of appellant, testified that although the loan which appellant made to Waterhouse

Company could not be considered as an investment, the company did expect to receive all or a part of the money loaned; that although the lender appreciated the risk which was being taken, it expected to receive the money back on the loan (Am. Fac. R. 532-533).

Mr. Edward J. Greaney, a certified public accountant, testified that he was asked to evaluate and did evaluate the assets of the Waterhouse Company as of January 31, 1931 (Am. Fac. R. 487-490). Mr. Greaney testified further that the sum of $260,000 was added as a cushion to take care of losses over and above those shown on the schedule (Am. Fac. R. 497-498). It was the opinion of Mr. Greaney that inasmuch as the value of the Waterhouse Company assets as reflected in various summaries prepared in connection with the audit exceeded the liabilities, the company was not insolvent (Am. Fac. R. 505-506).

The report of the Bank Examiner of the Territory of Hawaii indicates that subsequent to February 14, 1931, shortly after the Waterhouse Company was taken over by the Bishop Trust Company, sufficient assets appeared to be on hand to meet the liabilities of Waterhouse Company (Am. Fac. R. 554).

It is clear from the evidence adduced upon the trial of this cause that the payment made by appellant can in no sense be considered as a contribution. Not only was there no testimony to that effect by witnesses for either party, but on the contrary, appellant's witnesses testified directly that repayment was expected. In view of such evidence, the conclusion of the Trial Court that payment was just a contribution is clearly erroneous.

The Court also erred in finding that the note was contingent as to value and that it contained conditions which gave it no negotiable value (Finding of Fact No. XIII, R. 40). Under the provisions of the plan, the assets of Waterhouse Company were to be liquidated and after the payment

of liabilities a certain amount of the funds was to be paid first to Bishop Trust with the remainder then to be applied in payment of the notes. However, the fact that payment to the note holders was contingent in this respect does not support the finding of the Court that the note was contingent as to value. It may be true that the value of the note is less because it is payable only out of a particular fund, but that does not mean that the note possesses no value. The evidence indicated above shows clearly that appellant and other lenders loaned the funds upon a reasonable expectation of repayment and believed the note to have value at the time the loan was made. Moreover, the fact that a note is non-negotiable and thus transferable only by assignment may have the effect of rendering it less valuable but this should not be interpreted to mean that it is wholly without value.

In *Clay Drilling Company of Texas v. Commissioner of Internal Revenue,* 6 T.C. 324, the question presented to the Court was whether petitioner was entitled to a bad debt deduction aggregating $13,946.98. The latter sum was made up of two accounts representing debts owed by two individuals to petitioner's predecessor company. The Commissioner took the position that these two accounts did not represent "debts" which were due petitioner at the time they were charged off within the meaning of the statute and applicable regulations. The Commissioner contended that by virtue of a contract entered into with the debtors, the indebtedness to the corporation was canceled and forgiven. It was further contended that the contract provided a method for the debtors to pay said indebtedness by means of commissions on certain drilling contracts which were to be tendered to the corporation by the debtors and that the amount of the indebtedness was to be payable only as set forth in the contract and was not to be construed as a personal obligation to the debtors.

The Court held, however, that the debts were not canceled or forgiven by the terms of the contract entered into between the parties. In the course of its opinion, the Court remarked as follows:

"It seems to us that the debts of the Herschbachs to petitioner continued to exist, payable, it is true, only in the manner agreed upon. We know of no law which is to the effect that a debt is canceled and forgiven merely because the manner of its payment is restricted and it is agreed that the debtor shall not be personally liable if the debt is not fully paid in that manner. . . .

"Along somewhat the same line of reasoning, we think it is reasonable to hold that these accounts due by the Herschbachs to petitioner continued to be debts or obligations owed by the Herschbachs to petitioner, even though payable only in a special way and not out of the debtor's 'general funds,' so to speak. We therefore sustain petitioner on this phase of the issue. . . ."

In *Western Woodwork & Lumber Company v. Commissioner,* 6 T.C.M. 504, taxpayer's president owned a lot and proposed to a building contractor that the latter build a house thereon. An arrangement was entered into whereby the contractor agreed to build the house and when the house was sold taxpayer's president was to be reimbursed in an agreed amount for the lot. The agreement provided further that taxpayer was to furnish the lumber and mill work and that the builder's liability would be limited to paying taxpayer the agreed amount for lumber and millwork from the proceeds of the sale of the house. In 1929, after the completion of the house taxpayer received a note from the builder for lumber and millwork upon the further agreement that the latter would not be liable on the note except to pay the same out of funds received from the sale of the house. The builder attempted to sell the property but failed to do so until January, 1943. In 1935 the builder informed

taxpayer that he was ready to disclaim all hope of profit in the house and offered to deed the same to taxpayer free and clear. Taxpayer rejected this offer because the house with its mortgage was considered a liability rather than an asset. Taxpayer claimed a loss in 1943 when the house was sold. The claim was disallowed by Commissioner. The Tax Court upheld the Commissioner, not on the grounds that no debtor-creditor relationship existed because taxpayer had only a contingent claim as contended by Commissioner but because the worthlessness of the bad debt was established in 1935.

This case supports the contention of appellant that the mere fact that a fund from which a note is payable may prove insufficient to make the payment does not deprive the note of its character as a debt subject to being charged off and deducted as a bad debt when it becomes worthless.

The finding of the Court relative to the considerations for making the loan, i.e. the protection of the commercial community, sympathy toward clients of Waterhouse Company and other commendable desires and motives for helpfulness and security has no bearing on the deductibility of the loan. The law is well settled that the motives of the taxpayer in making a loan are immaterial in determining whether or not he is entitled to a deduction as a bad debt. See *Cooper-Brannan Naval Stores Co. v. Commissioner of Internal Revenue,* 9 BTA 105, 108.

Nor will a deduction as a bad debt be denied because the loan is not a "wise" loan. In *Austin v. Helvering,* 77 F. 2d 373 (1935), it was held that losses on injudicious loans made by bank officers were deductible as bad debts ascertained to be worthless and charged off within the taxable year. In *Redfield v. Eaton,* 53 F. 2d 693, plaintiff made certain advances of money to an actress who was then unemployed, upon the understanding that the actress would repay the loan as soon as she could get a job. The Court

held that the transaction constituted a bona fide loan even though an injudicious one and allowed the plaintiff to charge it off as a bad debt.

The record clearly shows that the note in question was ascertained to be worthless in the year 1932 and that appellant acted in good faith in making that ascertainment and charging it off as a bad debt.

Mr. Sherwood Lowrey testified that at the end of 1932 after discussing the matter with executives of American Factors, Limited (one of the other lenders), the conclusion was reached that the note was valueless and it was charged off on the books of the company (Am. Fac. R. 469-471). Mr. Carl Linden, employed as tax advisor by appellant, testified that after a discussion with executives of appellant and others, the conclusion was reached that there was no possibility of recovery on the note and that it should be charged off (Am. Fac. R. 543).

Alfred L. Castle also testified that he had made a study of the value of the note at the end of 1932 and had also concluded that the note was worthless and should be written off (Am. Fac. R. 512-515).

The Court's attention is also directed to the excerpt from the Bank Examiner's report in connection with the condition of Waterhouse Company at the close of business on December 31, 1932 to the effect that "an analysis of the various asset and liability accounts of the company made by us at December 31, 1932 disclosed according to our figures an insufficient amount of assets to meet the remaining liabilities" (Am. Fac. R. 554).

It is submitted to the Court that the note in question became worthless in 1932; that appellant did in fact ascertain the debt to be worthless in that year; that appellant acted in good faith in ascertaining the debt to be worthless in such taxable year; that the note was charged off as a bad debt in that year and that the deduction therefore is a proper

one which should be allowed in the computation of the income tax liability of Alexander & Baldwin, Limited, for the calendar year 1932.

2. In the alternative, if not deductible as a bad debt, the sum of $50,000.00 representing the amount paid to Waterhouse Company in 1931 was deductible as an ordinary and necessary business expense of Alexander & Baldwin, Limited in the year 1932.

Section 23 of the Revenue Act of 1932 providing for the deduction of ordinary and necessary expenses is as follows: "a. Expenses—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

In the event this Court should deny the deduction of the said amount of $50,000.00 as a bad debt ascertained to be worthless and charged off in the taxable year 1932, a deduction of $50,000.00 should be allowed appellant as an ordinary and necessary expense occurring in its business during the taxable year 1932.

The only finding by the Court relative to the deduction of the amount of $50,000.00 as an ordinary and necessary business expense was to the effect that there was no attempt to show that appellant would have suffered any material loss had it not attempted to keep Waterhouse Company a going concern (R. 20). It is respectfully submitted to the Court that the record in this case indicates that the Court erred in making such a finding.

Mr. Sherwood Lowrey testified that it would be disastrous to the community as a whole should the Waterhouse Company fail (Am. Fac. R. 465) and also that it was to the best interests of the company that the Waterhouse Company be assisted by the amount of the loan (Am. Fac. R. 474).

Mr. Dean, a director of Alexander & Baldwin, Limited, testified that one of the considerations for the making of the loan was the maintenance of the integrity and stability of the basic business enterprises of the Territory; that this is a small, isolated and closely knit community; that it would be a major disaster, the ramifications of which could not be forseen, if one of the trust companies were unable to meet its obligations (Am. Fac. R. 527).

In the case of *St. Louis Union Trust Company v. Sheehan* (D.C., E.D.Mo., 40-2 USTC 9585, 1940), one of the large banks in taxpayer's community was in danger of failure on account of runs. The taxpayer in this case was a trust company with very large sums of money on deposit in the First National Bank and it owned approximately one-third of the stock in that bank. After many of the citizens of St. Louis, including the taxpayer, decided that it was in their best interests for the business of the failing bank to be taken over by the First National Bank, a guaranty plan was devised to insure that the First National Bank would not sustain any loss by reason of their assumption of the liabilities of the bank which was in danger of failure. The guaranty in this case was not intended to add anything to the value of the assets of the First National Bank nor was there any thought of acquiring any additional business out of the transaction. The court held therefore that it could not be regarded in any sense as a capital expenditure.

As the court said: "The purpose of the taxpayer in executing its guaranty was to induce the First National Bank to take over the assets and liabilities of the failing institution, and thus remove from the business community the detrimental effects of a major bank failure. If the guaranty had not been made, the First National Bank would have refused to take over the failing bank. It was to induce it to do so that the taxpayer, along with other business concerns, participated in the guaranty."

The court held that taxpayer's contribution to the fund in 1931 was deductible as an ordinary and necessary business expense in the year 1936 because as the court said: "The amount of the loss under the guaranty was first definitely ascertainable in 1936, and it was then paid by the taxpayer."

In *Robert Gaylord, Inc. v. Commissioner* (41 B.T.A., 1119, 1940) the taxpayer corporation and a number of other business firms and individuals in 1931, signed an instrument of guaranty and deposited with the First National Bank in St. Louis the sum of $2,000,000.00 to induce it to take over the assets and assume the liabilities of the Franklin-American Trust Company which was on the verge of being closed because of its inability to withstand a run.

The petitioner was a Missouri corporation engaged in the business of manufacturing. It was not a stockholder or a depositor in the Franklin-American Bank. It was induced to subscribe to the instrument of guaranty solely because it believed it was for the best interests of the corporation. At a meeting held on December 21, 1931, which was attended by officers and representatives of banks, corporations and other businesses, the president of the St. Louis Clearing House Association informed the businessmen that the general banking situation was acute; that Franklin-American would be unable to open the following morning unless the guaranty were executed; that if it were allowed to fail, it would seriously affect all business, industry, and banking in the city. The board found that the petitioner signed the guaranty because of the belief that the failure of the Franklin-American Trust Company would jeopardize its bank accounts and accounts receivable in and near St. Louis, would paralyze its current business, particularly the Christmas trade, and in addition would cut down its prospective orders and future business.

The transaction was consummated and a loss of $12,451.58 was sustained by the petitioner. In the year 1936 the tax-

payer took this amount as a deduction from the gross income. The claimed deduction was disallowed by the Commissioner.

The petition filed by the taxpayer alleges that the deduction should be allowed as a loss under Section 23 (a) as an ordinary and necessary expense paid or incurred during the taxable year in carrying on a trade or business; under Section 23 (f) as a loss not compensated for by insurance; under 23 (q) as a contribution; or under 23 (k) as a bad debt. The Commissioner contended that the deduction was not allowable under any of the sections referred to above. It was his position that petitioner merely made a voluntary contribution; that it participated in the "rescue party" purely as a "matter of civic pride."

The Board of Tax Appeals held that the expenditure constituted an "ordinary and necessary" business expense within the purview of Section 23 (a). The Board said:

"That the expenditure in question was deemed by the taxpayer to be necessary for the protection of its own business cannot be doubted. The fact that it had no direct financial stake in the Franklin-American Bank is not determinative. The effect of the failure of this bank upon petitioner's business might well have been considerable. As pointed out by its president, it stood to lose upwards of a quarter of a million dollars through the collapse of the financial institutions of the community, which at that time was imminent. If the guaranty had not been raised and the apprehended collapse had occurred, it is entirely possible that petitioner's business would have been wiped out. This must have been in the minds of the officers and directors of petitioner when they authorized the agreement to be signed and the amount to be deposited. We think it must be held, therefore, that the expenditure was a 'necessary' one."

The Board had more difficulty in determining that the expenditure was "ordinary" as well as "necessary." The

Board pointed out that in *Welch v. Helvering,* (290 U.S. 111, 78 L. Ed. 212, 1933), the Supreme Court said: "What is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. . . . It is the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling."

The Board in holding that the transaction here was the "common and accepted means of defense" adopted by corporate businesses generally when faced with a situation such as that which confronted the businessmen of St. Louis in 1931, pointed out that banks and financial institutions were dependent first upon their own assets and secondarily upon such assistance as they might receive in times of stress, from their own stockholders, from other banks and from corporations and individuals who came to their rescue "either as a gesture of friendship or more frequently, as in the instant proceeding, as a matter of self-defense. The plan, devised and followed by the banks and businessmen of St. Louis, or some modification or variation, was being carried out in many sections of the country. . . . We think therefore it can not be gainsaid that in December of 1931 the transaction entered into by this petitioner was both 'normal' and constituted a then 'common and accepted means of defense' to protect it and its business from an imminent loss."

"We are of the opinion and hold that the amount in question is deductible as an ordinary and necessary expense of carrying on petitioner's trade or business."

It is to be noted that in the Gaylord case, the funds were paid out by petitioner in 1931 under the terms of the agreement. The deduction was taken in 1936 after the petitioner was advised that the amount of the guaranty was being taken. The court allowed the deduction in the year 1936.

In *Moloney Electric Company v. Commissioner* (42 B.T.A. 78, 1940) petitioner subscribed $5,000.00 to a

guaranty fund in order to induce a solvent bank to assume the liabilities of the Franklin-American Trust Company under the same circumstances as those existing in the Gaylord case referred to above. The Board reached the same conclusion in this case as it did in the Gaylord case, holding that the claimed deduction should be allowed under Section 23 (a) as an ordinary and necessary business expense.

In *Virginia Engineering Co., Inc. v. U. S. A.* (D.C.E.D. Va., 43-1 USTC 9495, 1943) the petitioner was engaged in the contracting business on a large scale and had considerable local investments in the city of Newport News. In 1931, the Schmelz National Bank, the second largest bank in Newport News, became involved in financial difficulties and was informed by the Comptroller of the Currency that it would be forced to close its doors unless a large sum of money was placed at its disposal. The First National Bank agreed to take over the assets and assume the liabilities of the Schmelz Bank, providing that an additional amount of money was contributed by banks, corporations and other businesses to guarantee the First National against a loss on the assets and liabilities of the Schmelz Bank.

The court found that the officers of the First National Bank determined that $127,000.00 additional would be needed to protect said bank and to justify its directors in taking over the assets and paying the depositors in the Schmelz Bank. The First National was induced to take over the Schmelz Bank in order to prevent it from going into receivership. It was believed that such action would seriously affect all banking and business within the city of Newport News; would cause a run on the other banks in the community and probably the failure of some of them; would paralyze real estate values, which were already low, and adversely affect all business interests in general.

The petitioner subscribed $10,000.00 to the fund. It had no money on deposit with the Schmelz Bank but had sub-

stantial deposits in two other banks in the city. Its investments in the stock of local corporations, loans to local real estate firms and corporations, and real estate held by it directly totaled a quarter of a million dollars. It also had local contracts amounting to millions of dollars. The officers and stockholders of petitioner believed that if the Schmelz Bank were forced into receivership, petitioner's bank accounts and investments would be jeopardized and that it would sustain heavy losses.

On December 31, 1931, a check of the Virginia Engineering Company for $10,000.00 was issued payable to the order of the Schmelz Bank. At the same time, a demand note of said bank was issued to the Virginia Engineering Co., Inc.

The court found that: "The advancement of the money to the Schmelz National Bank of Newport News, Virginia, and the acceptance of the note constituted a type of investment made frequently in the crucial period by business concerns, in this section of the country. The officers of Virginia Engineering Company and of 'Schmelz' believed in good faith that the note, or a very substantial part thereof, would be repaid."

The court concluded that the petitioner was entitled to deduct the amount of its loss as an ordinary and necessary business expense within the meaning of Section 23 (a). The court said: "In form it appeared to be a debt due from the bank to the petitioner, that proved worthless but, in substance and reality, the amount advanced to the bank was an expense incurred by petitioner in an effort to protect petitioner's vital interests. At the time the money was advanced there appeared to be a real chance that petitioner would be reimbursed for all or at least a part of the amount. This chance was dependent upon the bank's assets being more than sufficient to satisfy its obligation to the purchasing bank. The substance, not the form, of the transaction should be regarded. Transactions of this nature were not in-

frequent in the early thirties. It was not unusual then for large commercial concerns to lend financial aid to embarrassed banks in an effort to tide them over and thereby avoid general financial disaster in the community, that was likely to result in great direct loss to the concern rendering such aid."

"The deduction was properly taken in 1932. It could not be definitely ascertained whether or not the petitioner would be reimbursed in whole, or at least in part, for the amount advanced by it to the bank until about October 5, 1932."

The case of *First National Bank and Trust Company of Tulsa v. Jones* (143 F. 2d 652, Tenth Circuit, 1944) is not precisely in point but it does indicate that where advancements are made by a business firm without reasonable hope or expectation of a repayment and losses are sustained, such losses may be deductible as ordinary and necessary business expenses even though they may not be deductible as bad debts.

In the First National Bank case, supra, advancements were made for insurance premium on life insurance policies which had been assigned to the bank as security for the insured's indebtedness to it. At the time the premiums were paid there was no reasonable expectation that the insured would repay the bank. As a matter of fact as soon as the premiums were paid, the bank charged them off on its books. The court said: "Advancements made for insurance premiums, without reasonable hope or expectancy of repayment, are not debts and are deductible, not as bad debts, but as ordinary and necessary business expense when proper business precaution justifies such advancements."

The finding of the Trial Court that one of the considerations for payment of the $50,000.00 by appellant was the protection of the commercial community supports appellant's contention that the payment was necessary for the protection of its own business interests. In paragraph II

of the stipulation of facts (R. 55) it is shown that in 1932 Alexander & Baldwin, Limited was the agent for five companies operating sugar plantations, three companies operating pineapple plantations, two ranches and two railroad and stevedoring companies, all of which companies were local companies with total net worth of about $50,000,000.00; that appellant's investment in securities of the above mentioned companies totaled over $11,000,000.00 and that on December 30,1930, Alexander & Baldwin, Limited and the companies for which it acted as agent had on deposit in the banks of the Territory of Hawaii at least a sum of $2,275,000.00

It may be emphasized that in the Gaylord case, supra, as in this case, the government contended that the taxpayer had merely made a voluntary contribution; that it participated in a rescue party as a matter of civic pride and that the amount so paid was not an ordinary or necessary expense of carrying on its trade or business.

In a small closely knit island community such as the Territory of Hawaii the effect of the failure of the Waterhouse Company upon appellant's business would have been disastrous. The directors of Alexander & Baldwin, Limited were without authority to make and did not make a voluntary contribution to the Waterhouse Company. The payment was made as a calculated business risk for the primary purpose of preserving and safeguarding of the investment of appellant and of the companies for which it acted as agent in the community. Therefore, the payment of $50,000.00 to Waterhouse Company is deductible as an ordinary and necessary business expense of Alexander & Baldwin, Limited in the year 1932.

CONCLUSION

It is therefore respectfully submitted that Alexander & Baldwin is entitled to deduct the amount of $50,000.00 advanced to Waterhouse Company, which became uncollectible in 1932, as a bad debt or as an ordinary and necessary expense of doing business in the year 1932.

Dated: Honolulu, T. H., June 27, 1950.

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